GLOBAL LEGAL INSIGHTS

Banking Regulation

First Edition

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CONTENTS

Preface	Rachel Kent, *Hogan Lovells International LLP*	
Argentina	Javier L. Magnasco & Daniel Levi, *Estudio Beccar Varela*	1
Brazil	Christian de Lima Ramos & Ben Hur Cabrera Filho, *Ramos, Zuanon e Manassero Advogados*	7
Canada	Blair W. Keefe & Eli Monas, *Torys LLP*	15
Chile	Max Spiess & Juan Pablo Baraona, *Baraona Abogados*	23
Ecuador	Dr Boanerges Rodríguez Freire & Pedro José Izquierdo LL.M., *Coronel & Pérez*	34
Finland	Andrei Aganimov & Lauri Ahokallio, *Attorneys at Law Borenius*	43
Germany	Dr Maximilian von Rom & Sebastian Tusch, *Gleiss Lutz*	52
India	A.G. Karkhanis, K.A. Najmi & Vishakha Bhagvat, *Link Legal – India Law Services*	61
Indonesia	Rudy Kusmanto & Kus Endrawati, *Makarim & Taira S.*	73
Israel	Adv. Shiri Shaham & Adv. Yuval Shalheveth, *Yigal Arnon & Co. Law Firm*	82
Italy	Pietro Fulvio, Caterina Angela Marra & Marialuigia di Vincenzo, *Studio Legale Macchi di Cellere Gangemi*	92
Japan	Keiko Shimizu & Kensuke Suzuki, *Nagashima Ohno & Tsunematsu*	103
Kenya	Sonal Sejpal & Mona Doshi, *Anjarwalla & Khanna*	112
Luxembourg	André Hoffmann & Pit Reckinger, *Elvinger, Hoss & Prussen*	121
Mexico	Thomas S. Heather & Eugenio Sepúlveda, *Heather & Heather, S.C.*	131
Netherlands	Joris van Horzen & Joost Achterberg, *Kennedy Van der Laan N.V.*	139
Nigeria	Abayomi Adebanjo & Oluwaseye Ayinla, *Jackson, Etti & Edu*	147
Portugal	Ana Rita Almeida Campos, Hugo Moredo Santos & Benedita Aires, *Vieira de Almeida & Associados*	157
Russia	Philip W. Webb & Anna V. Maximenko, *Debevoise & Plimpton LLP*	166
Singapore	Elaine Chan, *WongPartnership LLP*	179
South Africa	Ina Meiring, *Werksmans Attorneys*	187
Spain	Fernando Mínguez Hernández & Íñigo de Luisa Maíz, *Cuatrecasas, Gonçalves Pereira*	195
Switzerland	Jean-Luc Herbez, Patrick W. Vogel & Adriano Antonietti, *Froriep Renggli*	207
Turkey	M. Kemal Mamak, Yeşim Api Şamlı & Meltem Küçükayhan Aşcıoğlu, *Hergüner Bilgen Özeke Attorney Partnership*	218
Ukraine	Yulia Kyrpa, Maryna Fedorenko & Kseniya Ostrovska, *Vasil Kisil and Partners*	234
United Kingdom	Michael Thomas, Dominic Hill & Steven McEwan, *Hogan Lovells International LLP*	245
USA	Brian C. McCormally, James W. Thomas, Jr & Christopher L. Allen, *Arnold & Porter LLP*	258
Uruguay	Juan Manuel Mercant & Marcos A. Payssé, *Guyer & Regules*	268
Venezuela	Gustavo J. Reyna & Carlos Omaña, *D'Empaire Reyna Abogados*	276
Vietnam	Dr Le Net, Dr Nguyen Thi Kim Vinh & Tran Thai Binh, *LNT & Partners*	284

Ecuador

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Introduction

Background

At the end of the 1990s, the Ecuadorian financial system faced a severe crisis that ended with the closure of more than half of the country's banks. Several factors contributed to the crisis, among which were the "El Niño" weather phenomenon that struck the country in 1998, the fall in oil prices, and a high level of debt in both the private and public sectors. The steady increase in defaulted debts, caused by the generally poor state of private business and by an acute fiscal crisis, gave rise to an atmosphere of distrust of the banks in the eyes of the public. People began to empty their bank accounts held in sucres (Ecuador's official currency at the time) in order to convert them to dollars, seeking thereby to protect themselves from the effects of an accelerated devaluation of the local currency.

To avoid a total collapse of the financial system, the government opted to freeze all the public's deposits. The result, however, was a depression of productive activity, illiquidity in the financial system and escalating speculation with the dollar. The unsustainability of the situation drove the President of the Republic, Jamil Mahuad, to adopt a structural solution that, in his own words, constituted a *"leap into the void"*. The solution was the formal dollarisation of Ecuador's economy with the Law of Economic Transformation of Ecuador, promulgated in March of 2000.

The following years saw our economy go through a slow process of recovery. In 2008, the government ceased its payment of a portion of the public debt corresponding to so-called global bonds (*"bonos global"*) 2012 and 2030, only to recover them again in a financial operation that was widely seen as successful. Indeed, only a marginal balance remained to be negotiated. The high price of oil, an aggressive plan of public investment, and a fiscal deficit financed through internal debt and international credits given by regional organisations and allied governments (among which China is the leading lender), allowed the economy to keep up its steady growth.

According to official figures, our level of public debt is currently adequate, and even under constitutionally-imposed limits − so much so that, at the beginning of April, the new heads of the Central Bank announced that the financial conditions are ripe for Ecuador once again to issue bonds in the international capital markets. This project is currently under consideration.

The 2008 crisis in the United States

In September 2008, President Rafael Correa announced that Ecuador had a well-financed budget and was preparing to *"depend on our own capacity"*. He said that if the financial crisis in the United States caused any adverse effects on the Ecuadorian economy and the prices of oil fell, the government would not interrupt its public works projects and the social programmes it finances. Rather, the only measure that would be taken, in an extreme case, would be to cease the payment of foreign public debt. In his message, he underlined that the first semester of 2008 had left Ecuador with a surplus of US$508m, and that *"the fiscal situation is absolutely healthy"*.

Sustained by this context, the private financial system has strengthened, aided by appropriate measures taken by the regulatory and control bodies. Even so, in April 2013 a private bank (albeit one with a marginal participation in the financial system) entered bankruptcy proceedings. This "isolated incident", as the Superintendent of Banks and Insurance termed it, will have no effect on the financial system, which is going through a period of great strength and liquidity.

Regulatory architecture: overview of banking regulators and key regulators

The sectors of the Ecuadorian financial system

Under the 2008 Constitution, the Ecuadorian financial system is composed of three sectors: public; private; and popular-caring (*"popular-solidario"*). Each of these sectors has its own set of regulations and autonomous control agencies in charge of preserving its safety, stability, transparency and solidity.

The law classifies the entities of the *private* financial system into three categories: financial institutions, financial services entities; and auxiliary services entities. *Financial services entities* include all general deposit keepers, leasing providers, credit card issuers or administrators, exchange houses, securities corporations, and those corporations dedicated to developing the secondary mortgage market. *Auxiliary services entities* include all those dedicated to the transportation of legal tender and securities, debt collection, and automatic teller machines, as well as IT services, export promotion, real estate developers that own property dedicated exclusively for use by a holding corporation or financial institution, and finally all those entities that are catalogued as such by the Superintendence of Banks and Insurance.

Banking institutions are a kind of financial intermediary that collects the public's resources and transfers them to the productive sectors of the economy to finance their activity. Aside from this traditional intermediation function, however, banks are authorised to undertake all the operations listed in article 51 of the General Law on Institutions of the Financial System, which regulates all those non-traditional activities that are nonetheless considered inherent or complementary to the financial sector.

Since 1994, a system of multiple banking has been in place in this General Law. Under it, each financial institution may simultaneously provide mortgage, commercial and investment banking services. The Law also gives legal recognition to so-called "financial groups", which may be configured in one of two ways:

1. as a holding corporation that owns a bank or another kind of private financial institution, investment and development corporation, financial or auxiliary services or other entity provided for in the General Law, as well as the local or foreign subsidiaries of any of these; or
2. as a bank, financial corporation, or investment and development corporation that owns financial or auxiliary services entities recognised in the General Law, as well as any local or foreign subsidiaries of any of these entities.

Whatever the structure of a financial group, it cannot contain more than one bank, financial corporation, or investment and development corporation. It also cannot contain a bank and a financial corporation or investment and development corporation. Finally, it cannot own more than one financial or auxiliary services entity dedicated to the same activity.

Financial services are considered public services

All financial activity performed by banks has been labelled by our Constitution as a public service that must be authorised by the State. Its proper ends are to preserve the public's deposits and to provide for the financial needs of the country's economic development. This qualification has received some criticism as an excuse to give the State a better legal and philosophical justification to interfere in the financial sector.

Banking regulation and oversight bodies

The General Law regulates the creation, organisation, activity, operation and liquidation of private financial institutions. It also contains provisions granting the Superintendence of Banks and Insurance the powers necessary for control and oversight of these institutions. The Superintendence, as well as the Banking Board (*"Junta Bancaria"*), as the highest control organisms of the private financial system, have the authority to issue binding resolutions and directives (*"instructivos"*) to all the institutions that form part of the system, in order to safeguard their levels of solvency and liquidity and to adjust their operations to international standards.

Recent regulatory themes and key regulatory developments in Ecuador

The professionalisation of the banking sector and underinvestment in other sectors

A major regulatory shift occurred in 2011, when a referendum celebrated on May 7 of that year reformed the Constitution to provide that the institutions of the private financial system, as well as their directors and principal shareholders, cannot be holders, either directly or indirectly, of any share or participation in companies that do not operate in the financial sector. A period of one year was provided for all these entities to transfer their stock and participations in these companies.

The original Constitution of 2008 already forbade all financial entities and groups, their legal representatives, board members and shareholders from having any participation in the management of the capital, investment, and property of media companies. In that case, a period of two years was given for these entities to transfer their holdings.

One of the provisions of the Organic Law of Market Power and Control states that any owners of stock or any other kind of participation that do not obey these prohibitions will be penalised with the suspension of all their stockholder rights in the corresponding financial institutions until the offending directors or administrators are removed from their positions. Simultaneously, the Superintendence of Banks will order the seizure of their stock or other participations in the financial institution, and their sale in a public auction.

Last tax-related reform

December 2012 saw the promulgation of the Organic Law for Redistribution of Income for Social Spending, which modified the tax regime applicable to banks.

The income tax applicable to banks must be paid over the totality of their income, ordinary and extraordinary, excluding all refunds, discounts, costs, and deductions applicable to that income. Under the Organic Code of Production, Commerce and Investment, promulgated in December 2010, the income tax rate for corporations would be applied in the following way: 24% until 2012; 23% for 2012; and 22% starting in 2013.

All corporations that reinvest their profits in Ecuador can obtain a ten-point reduction on the income tax rate applicable to the reinvested amount, as provided for in the corresponding regulations. Banks had been enjoying this reduction until the promulgation of the aforementioned Organic Law for Redistribution of Income for Social Spending, which was issued with the objective of financing a part of the increase in the amount given by the government to underprivileged citizens called the *"bono para el desarrollo humano"* or "human development bonus", a promise made by President Correa during the previous campaign.

This law seeks to tap the bountiful profits received by banks in recent years. It basically provides for the following:

1. banks are excluded from the possibility of benefiting from the reduction of the income tax rate given to reinvested profits;
2. all financial services are now subject to the value-added tax (VAT);
3. a new tax was created on all foreign-held assets, that is, all available funds and investments that banks own, either directly or through subsidiaries, outside the country;
4. the tax authorities now have the power to directly require banks to provide them with any information about their clients for purposes of tax management, control, determination and collection (this was particularly criticised by some as a breach of banking confidentiality (*"sigilo bancario"*); and
5. the Banking Board was given a new power to *"establish the maximum amount of compensation that administrators and legal representatives may receive from the institutions under their control"*.

The banking sector showed its discontent with the content of this law, which they consider to be unconstitutional and confiscatory. However, these complaints have not succeeded, and the new regulations were approved by the National Assembly and signed into law by the President, coming into effect in January 2013.

Bank governance and internal controls

Suitability qualification of stockholders

Before the Book of Stocks and Stockholders of a private financial institution is registered, the Superintendence of Banks and Insurance must qualify the liability, suitability and solvency of the stockholder, local or foreign, that owns or acquires at least 6% of the financial institution's capital.

The Superintendence will require all information and documentation that it deems necessary, and will qualify the stockholders' suitability. In case the qualification is not requested or is denied, the registration will be considered completely null and void. The Superintendence will declare this nullity and will penalise the administrator who authorised the registration with the penalties provided by law. The qualification may be requested by the financial institution itself, or by the person interested in the registration.

Qualification of legal representatives and board members

Before any administrator may take up their position in a financial institution, the Superintendence of Banks and Insurance must qualify him or her. To do this, it must analyse and verify the following:

1. his or her professional quality;
2. his or her previous experience in the administration of financial institutions and risk management;
3. whether he or she is affected by any of the causes of ineligibility contemplated in the General Law on Institutions of the Financial System.

Causes of ineligibility to hold the position of administrator or board member of a bank

The General Law states that the following may not be directors of a private financial institution:

1. managers, representatives or persons with power-of-attorney, internal and external auditors and any other employees of the financial institution and its subsidiaries and affiliates;
2. directors, legal representatives or persons with power-of-attorney, internal and external auditors of other institutions of the same kind;
3. anyone who has fallen into a delay of 60 days or more in the payment of any of their obligations with any financial institution;
4. anyone who, in the previous five years, has been subject to penalisation for delay or default by any financial institution;
5. anyone who at the time has a lawsuit pending against the corresponding private financial institution;
6. anyone who has been condemned for any crime, during the time the sentence is still pending;
7. the spouse, the relative within the fourth degree of consanguinity or second degree of affinity, and the adoptive parent or child of a principal or substitute director or employee of the corresponding private financial institution, unless they hold an express authorisation issued by the Superintendence;
8. anyone who has been legally incapacitated; and
9. minors.

Prohibitions 2 to 8 are also applicable to legal representatives, vice-presidents, managers, sub-managers, and internal auditors of a private financial institution, as well as to legal representatives of the entities that are designated as members at-large of the board.

Internal auditing

All the institutions that are subject to control by the Superintendence of Banks and Insurance must have an internal auditor. This person is appointed and removed at any moment by the stockholders or the organ that serves in its stead. In the case of a financial group, the same person may act as internal auditor in one or several of the institutions that comprise the group.

Qualification of the internal auditor

Only a person, not a corporation or other legal entity, may be an internal auditor. For this purpose, whoever aspires to this position must request to be qualified by the Superintendence of Banks and Insurance. This requires that he or she provide sufficient documentary evidence of his or her professional capabilities, as well as a minimum of five years of experience in internal or external auditing or similar functions in financial institutions. The corresponding qualification will be issued by means of a resolution signed by the Superintendence of Banks and Insurance.

Causes of ineligibility to be an internal auditor

The following may not act as internal auditors:

1. anyone who has been found ineligible to practise any commercial activity;
2. those who act as consultants to the corresponding financial institution;
3. anyone who holds a position in the organisations that regulate monetary and credit policy;
4. anyone who holds a position in the Superintendence of Banks and Insurance;
5. anyone who has defaulted or delayed in the payment of their obligations to any financial institution or insurance or reinsurance entity;
6. anyone who owns a checking account that has been closed down and not rehabilitated;
7. anyone who has been condemned in a final judgment of any crime, or has been judicially declared responsible for administrative irregularities in public or private institutions;
8. anyone who has been condemned in a final judgment for the commission of any offence related to money laundering;
9. anyone who has been sanctioned for professional misconduct;
10. anyone who presents false or altered documentation;
11. those who have so-called unpaid or "punished credits" (*"créditos castigados"*) in the past five years, that is, those credits which have not been timely paid and which the Superintendence therefore orders the bank to consider as a financial liability;
12. those who have any bounced cheque to their name for which justification is still pending;
13. those who have been a party to any lawsuit filed for or against the corresponding financial institution; and
14. anyone who, in the previous financial cycle, has served as an accountant in the institution where he or she will act as internal auditor.

Functions of internal auditing

Internal auditing is an independent and objective consultancy designed to add value and to ensure the correctness of an institution's operations. It helps to fulfill an organisation's objectives and to improve risk management, institutional control and organisational processes. It advises the general management in the development of internal controls.

Reports for the regulatory body

The internal auditors will present quarterly reports to the Superintendence of Banks and Insurance on the progress of the internal auditing plan, indicating the level of success of the stated objectives and completed activities, as well as any other aspects that are deemed relevant. The reports will also include an evaluation of the current state of the observations and recommendations that the Superintendence periodically formulates. When issued, the report will also be presented to the board or the organism that acts in its stead, so as to provide them with material to make informed decisions on the matters in question.

Sanctions

Internal auditors are subject to the following sanctions:

1. fines, in the case the report, or any other information requested by the Superintendence, is not timely presented;
2. written warning, in the case of negligence in the performance of their duties;
3. temporary suspension, for reiterated negligence or failure to comply with applicable regulations; and
4. disqualification, if there is any lack of truth in the information provided to the Superintendence or to an external auditor, if the internal auditor fails to comply with any professional or legal norms that apply to his or her function as an internal auditor, if he or she provides anyone with false or adulterated information, if it is demonstrated that the internal auditor has not applied the auditing norms or the regulations issued by the Superintendence of Banks and Insurance, or if he or she

has aided and abetted in the presentation of financial data that is not in accord with applicable regulations.

External auditing

The assembly of stockholders, or the organisation that acts in its stead, must appoint an external auditor from a list presented to them by the board, containing the names of auditors that have been qualified by the Superintendence of Banks and Insurance. The assembly also has the authority to remove the external auditor and designate their replacement within 30 days of his or her definitive absence.

The external auditor, whether a person or a legal entity, will be hired for a period of one year, and cannot provide these services to the same financial institution for more than five consecutive periods. Only legal entities (*i.e.*, corporations) may act as external auditors for banks, public financial institutions and any other public entities that the law places under the control of the Superintendence of Banks and Insurance.

External auditors are subject to very similar norms regarding qualification, ineligibility, reports, functions, and sanctions as those that apply to internal auditors.

Principles of good corporate governance

The institutions of the financial system must include internal policy guidebooks in their internal statutes and rules. Their organisational structure must be designed according to the principles of good corporate governance, which are binding on all the organisms of the institution, including the three powers that govern a corporation: stockholders; board of directors; and management. These principles regulate the design, integration and operation of the company's governing organs.

The basic principles of social responsibility that must direct corporate management are: compliance with the law; ethically responsible behaviour; respect for the preferences of interest groups within the corporation; accountability; and transparency.

Code of Corporate Governance

The board of directors of a financial institution must issue policies and institute processes that allow the institution to guarantee a healthy environment for the development of effective habits of transparency, administration and accountability. These policies and processes must be collected and formalised in a document entitled the "Code of Corporate Governance".

Advisory and administrative committees

The internal organs that provide support for the development of good corporate governance are: the committee of integral risk administration; the compensation committee; the ethics committee; and the enforcement committee.

Compensation committee

The compensation committee is charged with watching over the compensation of the institution's management. It will be composed of two members of the board, a representative appointed by the assembly of stockholders (who shall preside over it), and the general manager, principal administrator or legal representative. The members will appoint from someone outside the committee another person to serve as its secretary. All the members of the committee have a voice and a vote (except when it comes to determining the general manager's compensation, in which case he or she will not be allowed to speak or vote). The committee's decisions will be adopted by simple majority, and in the case of a tie, the president of the committee will cast the deciding vote.

Ethics committee

The ethics committee is composed of representatives of the stockholders, management, and employees. The number of representatives must ensure equality among these three parties, each of which must have at least one. The committee will be presided by the representative of the board, and the company's human resources chief will act as its secretary. Every member has a voice and a vote, and the committee will require a simple majority to adopt its decisions. In case of a tie, the president will cast the deciding vote. In order to serve on the committee, all members must all be qualified by the Superintendence of Banks and Insurance, which will demand that they satisfy the same requirements and be free from the same causes of ineligibility as those that apply to members of the board.

The ethics committee is charged with drafting the Code of Ethics, as well as determining the standards of internal manners and ways of proceeding. The committee must also fix restrictions on employees' actions, establish a procedure to avoid vices or conflicts of interest, and determine the appropriate sanctions for breach of ethical principles and duties.

Bank capital requirements

Equity capital

Banks' equity capital can be further analysed as authorised capital, subscribed capital, and paid capital. *Authorised capital* is the amount that is fixed in the incorporation contract, and it determines the extent to which a financial corporation may order the issue and subscription of stock. *Subscribed capital* determines shareholders' liability and consists in the part of the authorised capital that each stockholder commits to pay at the moment of incorporation. This amount can never be less than 50% of the authorised capital. Finally, *paid capital* is the amount that stockholders have in fact transferred over to the corporation. Before a financial institution may open for business, at least half of the subscribed capital must be paid.

Subscribers must commit to pay the remainder of the subscribed and unpaid capital in no more than one year from the date of subscription, or in any other moment when it becomes necessary to make up for any deficiencies in the institution's technical assets (see below), whether by virtue of a request made by the competent organ within the financial institution, or of an order issued by the Superintendence of Banks and Insurance.

Payment of capital increases

The resources used to pay for subscribed capital may only come from the following sources:
1. new contributions in cash or by credit compensation;
2. capitalisation of credits that are already due or about to become due, after they have been appraised by at least two independent risk assessment companies;
3. surplus from the legal reserve;
4. undistributed dividends;
5. special reserves, when they have been dedicated to this end; and
6. monetary contributions for future capitalisations authorised by the stockholders. In the case of a capitalisation made by credit compensation, credits that are due or about to become due, and undistributed dividends, the capital increase will require approval from the assembly of stockholders.

Notwithstanding the financial institution's own appraisal and calculation of the increase in subscribed capital, the Superintendence may perform any investigation it deems necessary in order to verify the legality of the payments and the origin of the funds.

Technical assets

With the objective of preserving their solvency, all financial institutions must maintain a series of technical relations as ordered by the Banking Board in a generally applicable resolution, which must follow international standards, particularly those established by the Committee of Basel. Specifically, they must maintain a relation of no less than 9% between their technical assets and the weighted sum of all their assets and liabilities. However, the Superintendence of Banks and Insurance may increase this percentage, but not without a favourable report from the Banking Board.

Deposit reserve or *"Encaje"*

All financial institutions that operate in Ecuador under the jurisdiction of the Superintendence of Banks and Insurance must maintain in reserve a percentage of the deposits they hold, as determined by the Directory of the Central Bank of Ecuador. This reserve is called *"encaje",* and will be held in deposit in the Central Bank, and only marginally in the hands of the financial institutions.

Interest rate systems

The Directory of the Central Bank of Ecuador will determine the general system of interest rates that will apply to all financial operations. Any modifications to the system that the Directory issues will govern only future operations, and can never have retroactive effect. In the case of medium- and long-term operations, the Directory will also determine the corresponding amortisation systems.

Rules governing banks' relationships with their customers and other third parties

Service fees

Service fees are the amounts that the Banking Board authorises banks to charge their clients and users for the effective provision of financial services. The Board must issue a quarterly list of the basic transactions that are by nature free, as well as a list of the financial services that are subject to maximum fees. The Superintendence of Banks and Insurance controls the compliance with the maximum fees and imposes the corresponding penalties on offending institutions. If a financial institution does not comply, they must also reimburse the amount illegally collected to the wronged client or user.

Ombudsman

In December 2008, a provision was added to the General Law on Institutions of the Financial System which introduced the figure of the ombudsman or client's defender. The ombudsman's function is to protect the rights and interests of the client. This initial provision was replaced with a more detailed legal regime in March 2012, which included special rules for his or her appointment and compensation. The Banking Board determines his or her powers, obligations, and term in office.

The appointment of the ombudsman corresponds to the Council of Citizen Participation and Social Control, an institution of the Ecuadorian State. He or she may not have any kind of link to the shareholders or administrators of the corresponding financial institution. The ombudsman's compensation is provided by the Superintendence of Banks and Insurance and is financed by specific contributions made by all the institutions of the financial system, both public and private, for that purpose.

Deposit guarantee (COSEDE)

The Law for the Creation of the Financial Security Net ordered the establishment of the Deposit Insurance Corporation (COSEDE for its initials in Spanish). It is a public entity with administrative and operational autonomy that is headquartered in Quito, and whose purpose is to administer the private financial system's deposit insurance regime. COSEDE replaced the Deposit Guarantee Agency (AGD for its initials in Spanish), which had been created by law in 1998.

The scope of the insurance includes all deposits made by persons or legal entities in any private financial institution, in whatever account or modality that is accepted by law.

The directory of COSEDE is in charge of annually revising the total coverage value, and putting it into effect every January.

Exclusion and transference of the assets and liabilities of unviable or bankrupted financial institutions

In order to adequately protect the public's deposits, and before declaring the mandatory liquidation of an unviable or bankrupt financial institution, the Banking Board must order the suspension of its operations in order to allow its assets and liabilities to be excluded from the liquidation and transferred to one or more other financial institutions. These institutions will take charge of these assets and liabilities under the same conditions under which the ceding institution held them. If this exclusion and transference is not completed within 15 days after the suspension of operations, the Board will order the institution's liquidation and direct COSEDE to pay the insured deposits.

From the date a financial institution's operations are suspended, the rights of its stockholders are suspended and its board members and managers are removed from office without the right to any kind of indemnification, even if they depend on the institution for their livelihood. The duties and powers of the board and of management will be assumed by a temporary or interim administrator to be appointed by the Banking Board.

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